The Real Estate
ANALYST

FEBRUARY 24
1959

APPRAISAL BULLETIN

Volume XXVIII

Number 7

Real Estate Economists, Appraisers and Counselors

THE SALE LEASEBACK TRANSACTION

BECAUSE of tax advantages, an increasing reservoir of investable funds, a declining supply of available desirable mortgage investments and a scarcity of conventional securities, other than Government bonds, a resurgence of sale and leaseback transactions has been created.

The classic sale and leaseback deal involves two simultaneous transactions: (1) an outright sale of the property to an unrelated investor, and (2) a leaseback of the same property to the seller. The lease, generally for a term of 20 to 30 years, is given by the buyer to the seller to assure continued and profitable use of the property sold.

This type of transaction can be, and is, easily adapted by investors other than those charged with the placement of institutional funds. The principle can be applied to almost any type of property -- large or small. The transaction permits the seller to retain full possession of the property and provides the buyer with an outlet for his investable funds. The rental payment agreed upon must be sufficient to provide a return on the investment plus amortization of the purchase price in the case of a net lease. The amount representing the rate of return is often higher than the interest charged for a loan as big as the sales price of the property.

There is some latitude in both directions in arriving at the rental value of the property and its price. Naturally the buyer-lessor wants to recover his investment in the shortest period of time, and would prefer an arrangement calling for high rental in the early years of the lease with a lower rental in the later years. However, the tax authorities could look upon the excess rental in the earlier years as prepayment of rent for the later years, thus disallowing a tax reduction in the amount of the excess in the year it was paid.

The rental payment, made by the seller, based on the current value of the property indirectly amounts to a deduction which includes amortization of land value and depreciation of the building. This is a particular advantage to the seller whose building is about fully depreciated or has increased in value. The profit made on the sale would be taxable, but taxable at the capital gain rate of 25%.

The sale leaseback transaction frees the seller's capital that would otherwise be tied up in property ownership and obtains for him current deductions for rent. His credit is less restricted than it would otherwise be if a loan were negotiated for the amount of the sale and he would not be encumbered with the restrictions that go with making a loan. Furthermore, the balance sheet would look more favorable to its owners.

The building facilities, already tailored to the tenant's needs, are protected under the terms of the lease. As a tax advantage, rental payments are 100% deductible from taxable income. It is true, depreciation deduction is lost when the property is sold, but the rental payments generally exceed the depreciation allowance on the property.

In many cases, the terms of the lease require the tenant to pay real estate taxes and the costs for repairs, maintenance and alterations. These items may be annually deducted from taxable income over the term of the lease. Furthermore, profit on the use of the cash secured by the sale, may be greater than the interest figured in the rental. If the deal involves undeveloped land, a deduction is created for the value of the land that did not exist before.

One of the chief advantages to the buyer lies in securing his investment in the property through a long-term lease. This particularly appeals to insurance companies and tax-exempt corporations seeking long-term investments for their excess reserves.

In the case where the landlord is not a tax-exempt organization, the depreciation allowances are deductible from net income, thus making the return partially tax free. This depreciation allowance is one of the major considerations to an investor seeking a tax benefit as well as his getting an investment return on his property. Furthermore, should the property appreciate in value and the landlord sells, he is faced with paying only the 25% capital gains tax on his realized capital gain rather than the higher tax rate imposed on ordinary income.

The return on his investment from leasing may be larger than it would be if his funds were placed in other areas of similar risk. For instance, he may be able to sell his property at a profit, but in years when markets are oversold he may have to take a large cut in his profit. Therefore, leasing could bring a return closer to, and more consistent with, his normal profit and may in fact exceed it.

Leasing also defers income over a long period which may pay off in after-tax money should a cut in rates occur.

When a bona fide lease of depreciable property is made, it is converted to a capital asset. This may result in converting the owner's profit to capital gain if a subsequent sale of the leased property is made.

Disadvantages of a sale and leaseback transaction, though few, do exist for both parties involved.

As soon as the transaction has taken place, the seller of the property has reduced his freedom of action. If the ownership of the property were retained and better opportunity appeared elsewhere, the owner could sell and move. This mobility is restricted because the new tenant-seller is tied to a long-term rental contract. The lease can be burdensome. With neighborhoods changing as rapidly as some of them are (and frequently for the worse), the leaseholder could be hit hard by an adverse changing community. It is true that most leases contain a cancellation provision but the costs may be high even though a deduction from taxable income is permissible.

Finally, if the real estate sold appreciates in value during the term of the lease, the landlord and not the seller-tenant, gets the ultimate benefit.

There are also disadvantages to the landlord in a sale and leaseback transaction. The landlord's income depends upon the tenant's ability to meet the rental obligation under the terms of the lease. In such cases instead of acting on the basis of the value of the real estate, the buyer-lessor may act on the seller-lessee's credit standing. Because the rentals received on property reflect a percentage of the invested capital, the buyer-lessor could reasonably pay more than the appraised value of the property. With a change in market conditions, the demand for the lessee's product could be decreased, converting him from a good tenant to a poor one. Some of us still remember that gilt-edged credit ratings in the 1920's proved quite disappointing in the 1930's.

Furthermore, if the tenant becomes insolvent and unable to pay his debts, the landlord has limited rights. He is not a protected creditor. Because the sale and leaseback transaction usually involves an investment of substantial size, the landlord could be putting too many eggs in one basket. The value of his investment could decline. Even if it does not, investment opportunities could develop elsewhere promising a greater return. The landlord, like the tenant, is tied to the long-term lease.

Finally, the landlord's tax position may be changed. This happens in the case of charities. On a sale and leaseback transaction, charities are faced with a tax liability if the lease extends for a period exceeding 5 years and if a large portion of the funds used by the charity to make the purchase is borrowed.

Several specific factors should be considered in making the sale and leaseback transaction.

The sale, as well as the lease, should be based on a fair market value. The lease should not exceed 30 years and should not include provisions for a repurchase of the property unless it is based on the going market price at the end of the lease term.

The Tax Court could view the sale and leaseback transaction with a dim eye if there is an agreement to resell the property to the tenant at some future date; if the selling price is out of line with the market price; and the agreed rental does not compare favorably with the current rental rate.